> The basic cable tier should not be required to bear a larger portion of the joint and common costs than would be allocated on a per channel basis.[81]

> The law does not necessarily intend that joint and common costs be recovered on a per channel basis.[82]

The reasons that the Commission can go below the limit of a per channel allocation include the presence of public, educational, governmental and leased access channels on the basic tier, as well as the possibility that the Commission would decide as a "policy matter to keep the rates for basic service as low as possible."

While there would appear to be social reasons for choosing to allocate joint and common costs to the basic tier resulting on a less than per channel basis, we believe there is also an economic reason. The nature of the engineering and design of multiproduct systems is such that the most demanding service sets the technical level to which the system must rise. It is extremely difficult to sort these cost-causative factors out in cost allocation, but we believe that the technical sophistication of cable systems is not driven by the demands of basic services; it is driven by non-basic services.

---

[81] Conference Report at 63.

[82] Conference Report at 63.

The monopolist's tendency to allocate all the joint and common costs to the inelastic basic service tier and then price unregulated services at the margin is explicitly rejected in the Act. The regulated basic tier must not be permitted to serve as the base that allows for marginal cost pricing of unregulated services.

It is crucial here to note that the conferees cast these principles in the broadest terms possible to reach unregulated services. While the Act explicitly and directly regulates basic services and cable programming services, in the discussion of basic rates in § 623 (b), it precludes the misallocation of direct costs for all non-basic services and unregulated services. In contrast, the discussion of cable programming services in § 623 (c) clearly excludes per-program and per-channel services. By using very broad terms in 623 (b) and explicitly narrowing the considerations in 623 (c), the Congress cast a very wide net in 623 (b). This is especially important in the consideration of profitability which is discussed in the next section.

2. PROFITABILITY

We have already pointed out the close linkage between reasonable profits and prices through the preclusion of monopoly profits. The Conference Report goes somewhat farther. The conference explicitly expanded the consideration of profit from

solely profits on basic services to a much broader view.

> The language concerning "reasonable profit" was amended to strike "on the provision of the basic service tier" and to substitute "consistent with the Commission's obligations to subscribers" to ensure that rates are reasonable.[83]

While "cable operators are entitled to earn a reasonable profit," these profits must be "consistent with the goal of ensuring that rates to consumers are reasonable." The Conference Report makes it clear that profits on all services can be considered.

> Further, the changes included in the conference agreement would allow the Commission to examine the profit earned by the cable operators on <u>other cable services</u> as well as the profit earned on the basic cable service tier in determining whether the rates for the basic service tier are reasonable. The intention of this change is, once again, to protect the interests of the consumers of basic cable service.[84]

While the examination of profits falls short of a full regulatory scheme of rate-base, rate-of-return regulation in which a revenue requirement is set across all services, this discussion does suggest revenue restraint across all services.

For example, suppose the Commission observes high rates for basic service, but low profits there because high costs are

---

[83] Conference Report at 63.

[84] Conference Report at 63.

allocated to basic. This could occur if basic is composed of a large number of channels with low value programming and a per channel allocator for common costs is used. At the same time, the Commission could observe high profits on pay-per-view service, but low costs allocated there. It could also observe unreasonable profits system-wide. It could, under this provision, order a reallocation of costs from basic to other cable services and lower basic rates, with a reduction of the overall profitability of the cable operator.

3. RETIERING

The concern with manipulation of cost and profit is reemphasized in the Act and Conference Report with the prohibition on evasion through retiering. What the cable operators are prevented from achieving by the shifting of costs in §s 623 (b) and (c), they are also prevented from achieving by the manipulation of quality in the basic tier in § 623 (h).

> The conferees recognize that many cable operators have shifted cable programs out of the basic service tier into other packages and that this practice can cause subscribers' rates for cable service to increase. The conferees are concerned that such retiering may result in the evasion of the Commission's regulations to enforce the bill. The conferees expect the Commission to adopt procedures to protect consumers from being harmed by any such evasions.[85]

---

[85] Conference Report at 65.

If the shifting of service between tiers results in excessive increases in rates for a set of services previously considered basic, or of profits above reasonable levels (on basic services, or overall), then those rates must be rolled back. Whether the retiering occurred in the past or takes place in the future does not matter. It is the condition of excessive rates and unreasonable profitability which Congress pinpointed as the wrongs that must be righted.

B. THE DETAILS OF RATE REGULATION

At the most concrete level, the Act specifies approaches to the handling of specific categories of costs and factors to be considered in the setting or overturning of rates. As Table V-1 shows, there are essentially three categories of services -- basic services, cable programming services, and other services (including at least per-channel and per-program services). Each of these is subject to its own specific form of regulation.

1. PER-CHANNEL OR PER-PROGRAM SERVICES

We deal with these services first since they are the most easily handled. Except for the prohibition on cost shifting and marginal cost pricing, the Act prohibits regulation of these services. These services must cover their direct costs and make a contribution to joint and common costs (they cannot be priced

TABLE V-1:
DETAILS OF RATE REGULATION APPLIED TO CATEGORIES OF SERVICES

REGULATORY CONSIDERATION	CATEGORIES OF SERVICES		
	BASIC SERVICE	CABLE PROGRAMMING	PER-CHANNEL PER-PROGRAM
SPECIFIC RATE STANDARD	REASONABLE	NOT UNREASONABLE	NO MENTION
RATES ON SYSTEMS SUBJECT TO COMP.	CONSIDERED	CONSIDERED	NO MENTION
ADVERTISING AND OTHER REVENUE	CONSIDERED	CONSIDERED	NO MENTION
JOINT AND COMMON COST	NO MORE THAN PER CHANNEL	CAPITAL AND OPERATING CONSIDERED	MORE THAN DIRECT
DIRECT COSTS	BASIC TIER Programming Fees/taxes Franchise obligations ACTUAL COST FOR: Equipment Installation Changes in service	CAPITAL AND OPERATING	NO COST SHIFTING
PROFIT	REASONABLE	PROFITABILITY CONSISTENT WITH THE GOAL OF ENSURING THAT RATES TO CONSUMERS ARE REASONABLE	
RATE COMPARISONS	NO MENTION	MANDATED: Similarly situated History Rates as a whole (except) Per-Channel/ Program	NO MENTION
OTHER FACTORS	NO MENTION	CONSIDERED	NO MENTION

as purely marginal services). In the context of reasonable rates for basic service, the profitability of these services can be considered.

2. BASIC SERVICES

Basic services are regulated with the greatest detail. As noted above, rates for basic services must be reasonable. The Commission has the affirmative obligation to ensure that this is the case.

In regulating the rate for the basic service tier, the Commission is supposed to reduce the administrative burden in carrying out its fundamental obligation (as discussed above). It may do so by formula, but it must take into account

- rates on systems subject to competition;
- direct costs of programming;
- the reasonable and proper allocation of joint and common costs (as discussed above);
- revenues received by cable operators from advertising and other consideration;
- the reasonable and proper allocation of local and state fees and taxes;

- o the cost of franchise required public, educational or government channels or other franchise services; and

- o reasonable profits (as discussed above).[86]

Thus, the law identifies six categories of cost/revenue. Rates can generally be estimated as follows

Rates = Direct Cost

+ Franchise Cost

+ Reasonable and Proper Allocations of Joint and Common Costs, Fees and Taxes

+ Reasonable Profits

- Advertising Revenue and Other Consideration

In the Conference Report's discussion of the allocation of fees and taxes reference is made to the allocation of joint and common costs. That discussion is relevant here as well.

The Conference also made it clear that the consideration of advertising revenue and other consideration obtained by cable operators was intended to help keep rates low for basic services. Therefore, we subtract these revenues from basic service rates.

---

[86] § 623 (b)(2)(c).

Congress did not stop there, however. It did not intend that cable operators can simply generate high levels of cost and pass them through to subscribers. The goal was to achieve competitive market outcomes.

The comparison with systems subject to competition ensures that the efficiency-enhancing characteristics of competition are recognized in Commission regulation. That is, firms not subject to competition may be inefficient, thereby generating large costs, but the goals of the Act are not satisfied if the Commission just ratifies these inefficient costs. The Congress wants subscribers to pay no more than would prevail if competition were prevalent. It has told the Commission to build this dynamic factor into its regulation.

3. RATES FOR CABLE PROGRAMMING SERVICE

Cable programming services are the third category of services identified in the law which are involved in the overall plan of rate regulation. They are directly regulated through a complaint procedure. There are some ways in which the regulatory scheme applied to these services is identical to that for basic services, some which are similar, and some which are different.

Cable programming services are subject to the identical

treatment as basic programming in terms of the Act's requirement of a comparison with systems subject to effective competition. Since competition is the key economic standard embraced by the Congress in the Act's goals section and it is reiterated in the regulatory section, this is a major factor that should be considered by the Commission.

Cable programming services are also subject to the same regulatory approach when it comes to taking advertising revenue and other consideration into account. Congress clearly intended for these sources of revenues to diminish the burden on subscribers.

Areas of similarity involve profitability, cost and the rate standard. Unlike basic services, the profitability of cable programming services is not directly the subject of regulation. However, as discussed above, profitability of these services is constrained by the overarching determination that cable operator profits should only be reasonable and that the rate of profit on non-basic services should be taken into account in determining basic rates.

The regulatory approach to cable programming services identifies two broad categories of cost -- capital and operating costs -- to be taken into account in regulating these services. These are broad categories which encompass the detailed

categories identified for basic services.

The rate standard for cable programming services is flipped over, compared to basic services. Whereas rates for basic services must be reasonable, rates for cable programming services cannot be unreasonable. The economic and legal definition of reasonable and unreasonable are two sides of the same coin. If Congress had intended for a not unreasonable rate to be higher than a reasonable one, it certainly would have chosen a different word. The difference appears to be in the process for determining the line of reasonableness and the factors considered.

This is where the differences between basic service and cable programming services come into play. First, while the Commission has the pro-active obligation to ensure that rates for basic service are reasonable, it has the reactive task of determining where rates for cable programming services are unreasonable. The burden of initiating the process of rate determination falls on intervenors in the case of cable programming services.

Second, in addition to the differences of cost analysis and profit review identified above, the Commission is required to consider a number of other factors in determining whether a rate for cable programming services is unreasonable. It must consider

- rates charged by similarly situated systems,

- the historical pattern of rate increases,

- the overall pattern of rates (except those for per-program or per channel services), and

- other factors.[87]

Congress outlined detailed cost factors to arrive at reasonable rates for basic services; general cost and other factors to arrive at unreasonable rates (by complaint) for cable programming services; and key cost allocators and an overall consideration of profits for unregulated services. Congress prefers a competitive standard if one can be found, but if regulation is necessary, it should be cost-based and minimize the administrative burden on subscribers to basic service.

[87] § 623 (c)(2).

VI. A PRACTICAL APPROACH TO CABLE RATE REGULATION UNDER THE ACT

A. IMPLEMENTING COST-BASED REGULATION

This section describes the approach that the Commission should take to implementing the rate regulation provisions of the 1992 Cable Act. The practical problem of implementing the type of cost-based regulatory scheme enacted by Congress can best be handled through the regulatory system described below.

1. EFFECTIVE COMPETITION

As pointed out in Section II. supra, the Congress directed the Commission to rely on price comparisons between monopoly cable systems and systems subject to effective competition if it can. Unfortunately, for the foreseeable future the Commission will not be able to do so for lack of a sufficient number of examples.

To move toward this goal, the Commission must first identify situations where effective competition exists. Effective competition is both the ultimate objective of the Act and a regulatory standard invoked for both basic services and cable programming services.

The Commission will find, at least until the procompetitive

provisions of the Act have had an opportunity to take effect, that effective competition, as defined in the law, is virtually non-existent. By most counts, less than one percent of all cable systems are competitive.

Nevertheless, attention to the behavior of even the small number of systems subject to competition is important in the near term. First, the Commission should develop analytic approaches for understanding how these systems price services, what their profitability is, etc. As the number of systems subject to competition grows, the Commission may ultimately be able to use effective competition as a broad regulatory tool.

Second, the behavior of these competitive cable systems provides a very important picture of how prices should be set. Even as general guides, competitive market forces provide the best standard for judging pricing behavior.

2. COST-REGULATION

Since effective competition is lacking, the Commission should begin to implement a system of cost-based regulation. We call this detailed-cost-based regulation. Specifying such a system will be difficult, however. Accounting practices across the cable industry are not uniform, circumstances vary, and methodologies are lacking in the short term.

If effective competition fails to materialize, the Commission is charged with instituting a system of regulation that relies on a detailed identification and allocation of cost for basic services, and a general analysis of cost and other factors for cable programming services. That system would include not only the six categories of cost identified in the Act, but also some standard by which to measure profitability of basic services, as well as the overall profitability of cable operators.

Developing this cost methodology will be a formidable task. The cable industry was not regulated on a generally uniform cost-basis prior to deregulation in 1984 and it has not been subject to reporting or accounting requirements since. We believe the Commission, through its data gathering activities, should develop regulatory approaches that allow general categories of cost to be identified and reported. As the Commission becomes more familiar with the cost characteristics of different types of systems, it can develop a relatively easily implemented cost manual. We believe that there is an alternative that can readily be applied while the Commission develops its detailed cost-based approach.

3. FORMULAIC, GLOBAL COST-BASED REGULATION

We recommend that the Commission commence with a strategy which relies on a global formulaic cost approach to rate

regulation, while it develops its comparative competition and detailed-cost-based methodologies.

The global formulaic cost approach need only remain in place until the Commission is satisfied that it has adequate information to pursue one of the preferred alternatives. If effective competition proliferates, the Commission may abandon cost-based methodologies altogether. If market power persists, the Commission could assess whether shifting from a global-cost-based system to a detailed-cost-based system is in the public interest, given the goals of the Act.

Assuming that cost-based regulation of some form remains necessary, the Commission should compare the results of the global and detailed approaches to cost-based regulation on an annual basis. This could be accomplished by identifying representative types of systems -- representative by cost characteristics such as size, density etc. -- and doing detailed analysis of a small number of systems.

We believe that the Commission has more than adequate information to begin rate regulation with a global, formulaic approach to cost estimation. A variety of data are available, including detailed information on rates prior to deregulation, considerable econometric analysis of the economic and cost-characteristics of the cable industry, and studies of the pricing

behavior of systems subject to competition.

A global, formulaic approach that takes these types of data into account and allows challenges from either side will be reasonable from both the subscriber and operator point of view. Rates based on a formulaic, global cost approach should be subject to challenge as too high or too low, based on detailed cost information presented by subscribers/intervenors or cable operators.

B. A SPECIFIC PROPOSAL TO ENSURE REASONABLE RATES.

1. ESTABLISHING BASIC RATES

a. Choosing a Base Year

The global formula should start from a particular cable system's rates in effect at some time prior to deregulation. A case can be made for either 1984, when the 1984 Cable Act passed Congress, or 1986, the date when rate deregulation was implemented.

The year 1984 may be preferable to 1986 for two reasons. First, Congress had allowed for automatic five percent increases for 1985 and 1986 that were not related to actual changes in cost. Second, knowing that deregulation was coming, operators may have been gaming the system between 1984 and 1986 in a

forward-looking manner. One might have to go back to 1983 to avoid this gaming effect.

Rates at these dates can be assumed to be reasonable since they were subject to regulation, or local authorities had not chosen to regulate (perhaps because of the existence of competition). It should be recognized, however, that even these rates may not be reasonable, by the cost-based standards that Congress imposed in the 1992 Cable Act. Regulation of cable rates was generally not based on cost-of-service regulation. The competitive franchising process was the only driver of rates. However, one would expect the bidding process, if truly competitive, to drive proposed rates toward costs.[88]

Under no circumstances can the Commission consider a base year after 1986, as a source of reasonable rates. After 1986, deregulation unleashed the exercise of market power which was not disciplined by either regulation or competitive market forces.

---

[88] Given the Commission's data constraints, we have intentionally proposed a global formulaic model that is more generous to cable operators than Congress' "reasonable" or not "unreasonable" pricing standard should allow for. However, to ensure parallel regulatory treatment for basic tier and cable programming service, and until detailed cost data are available, we believe this loose global formulaic benchmark generally approximates Congress' goals.

b. Choosing an Escalator

Starting from a base year in which rates were reasonable, the Commission should estimate cost-based increases, taking into account the characteristics of the industry. We believe that the Commission should establish reasonable 1993 levels using the Gross National Product Price Index (GNPPI), applied to the base year rates for basic service, or the most popular service tier, where appropriate.

GNPPI incorporates normal productivity advances in the economy, but not the unique economic dynamics of the industry.[89] Therefore, after estimating an average monthly rate in 1993, the Commission should then divide by the total number of activated channels on the particular cable system available in 1993 minus channels leased pursuant to § 9, to establish a per channel rate. Rates should be lowered to this level.

Before the per channel rate is calculated, the Commission must back out equipment costs, if they had been included in rates in the base, pre-deregulation year. These costs will be

[89] For example, if a steel manufacturer implements a new process and drives down the price of steel, this will be reflected in the price index. This is true of every sector in the economy. Each individual sector will influence the overall index in a small way and the index will reflect the economy-wide productivity improvements. If one sector does very much better than others in the economy, this will have only a small impact on the overall index.

recovered directly, at cost, as mandated by Congress. See § 623 (b)(3).

By escalating the monthly rate to 1993 and then calculating the per channel charge, subscribers receive the benefit of system expansion, which had been the case prior to deregulation and would be the case in a competitive industry. Moreover, as we have noted (see Section III. supra), the industry exhibits declining marginal costs per channel, making it inappropriate to simply escalate per channel rates by the GNPPI. Such an approach would allow vastly excessive rates per channel, since it disregards the declining marginal cost of adding channels.

c. Future Rate Changes

Once the base year level of reasonable rates is identified, the Commission should use GNPPI as an inflator. However, on a going forward basis rates should be adjusted downward to take account of any growth in advertising revenue and other contribution. This is explicitly required in the Act. An industry-wide index can be used to capture future growth in these revenues.

Moreover, system growth should continue to be reflected in per channel rates by spreading all costs across all channels. This is required in order to meet three explicit dictates in the

Act (as described in Sections II. and V., supra):

> Joint and common costs must be allocated to all channels,
>
> No marginal cost pricing of per channel or per program services is allowed, and
>
> Rates for basic services should be kept low.

According to the Act, the Commission must not allow operators to add channels at "incremental" cost only. Any additional channels must be able to bear their fair share of all costs. Adjusting system average per channel charges for future channel expansion accomplishes this. If channels can be added at a value above the system average, they should be because they will cover their costs. This is what Congress intended by economically justifiable expansion in § 2(b)(3).

Moreover, by establishing a per channel rate based on all channels, we also account for the fact that cable operators bundle access to non-basic tiers and services in the basic tier price. As noted in Section IV. supra, this bundling under deregulation, without effective competition, introduced a major exploitative factor into cable's price structure. Thus we believe a system-wide per channel average is crucial to protect consumers.

It should also be noted that the per channel approach

combined with the indexing of rates to GNPPI leaves major incentives for cable operators to provide innovative new services. Successful new programming can generate high profits (subject to the overall profit consideration). Moreover, we recommend utilizing only activated channels, not total channel capacity, to ensure a reasonable opportunity to recover revenue.

In other words, if a cable operator adds an active channel, it must recover a fair share of the joint and common costs in the prices charged for that channel. This is accomplished by spreading all costs across the new (larger) number of channels and assuming, the operator will cover the system average price per channel. It could not recover these costs from an inactive channel, so we use active channels, not total capacity in our formula. Under this formulaic approach, the operator will think carefully about lighting up channels, since it has to recover costs. At the same time, under the formula, the operator will be allowed to keep the profits, earned from very successful new offerings.

This rate would be a cap on charges for channels in the basic tier. Under certain circumstances, as discussed below, the operator might want to price below this cap. Moreover, there are adjustments that must be made to this cap and other constraints on pricing that must be taken into account in order to meet the dictates of the Act.

B. OTHER CONSTRAINTS ON RATES

Having specified an approach to establishing reasonable basic rates, we turn to the other major constraints on rates required by Congress.

1. UNREASONABLE RATES FOR CABLE PROGRAMMING SERVICES AND RETIERING HARM

By establishing a per channel limit in the basic tier, cable operators will have an incentive to provide a very thin basic tier, if they think they can move programming to another tier where prices are not constrained. However, in the other tiers -- cable programming service -- Congress required the Commission to establish similar rate restraints. These rates cannot be unreasonable and subscribers cannot be harmed by retiering to evade the intent of the Act (see our discussion of Congressional intent in Section II. supra).

In order to implement these two provision in conjunction with a global formulaic approach, we believe that the Commission must establish a clear standard by which to evaluate retiering. If the Commission were to adopt detailed cost based regulation, this would be less of a concern, since careful cost allocation would have separated cost and provided the public with a much greater ability to identify unreasonable rates for cable programming service.

In the context of a global formulaic approach, which utilizes a per channel average, two simple standards will protect the public. First, the Commission should identify the set of services which consumers have traditionally received as basic services. By traditional we mean those cable programming services -- largely cable networks including distant signals -- which have been included in basic service or expanded basic service.

We recommend identifying the maximum number of programs in the top 30 nationwide programs, which were offered by the cable operator in the basic and expanded basic tiers.[90] This standard should ensure that the rates subscribers pay for the combination of basic and cable programming services that have traditionally been part of basic service (i.e., signals that shall be in the basic tier under the Act, plus the 30 most popular national cable networks, including distant signals) does not cause harm.

The cap would be calculated as the per channel charge multiplied by the number of channels in the "traditional" package. As long as the bill for this set of services is below the cap, no retiering harm would be imposed and rates would not be unreasonable. Moreover, the operator could price basic services below the per channel index, and other cable programming

---

[90] Consumer Reports, 1991, op. cit., shows a total of 34 non-broadcast shows in its survey of consumer reactions to programs.

services above that level, so long as the charge for basic and cable programming service, added together, does not exceed the per channel cap.

In other words, two conditions would be necessary for a finding of retiering harm or unreasonable rates in traditional cable programming services. Specific programming services would have to be priced above the system average per channel index and the traditional basic service package cap would have to be exceeded, to trigger regulatory rate reductions.

This approach would not only be a specific and easily implemented approach to two of Congress' primary goals in the Act -- preclusion of retiering harm and ease of challenge to unreasonable rates for cable programming service -- it would preserve the incentive to provide a low priced basic tier. Cable operators could make up revenue for below-average-channel pricing in the basic tier by above-average-pricing in the other tiers, as long as they impose no harm by retiering (i.e., as long as the overall price per channel is within the Commission's overall price cap).

It should be stressed that in order to prevent evasion through retiering, the formula outlined above must be applied to any tier of programming in which any of the top 30 cable programming services, traditionally included in the basic tier,